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Pakistan's Economy: Achievements, Progress, Constraints, and Prospects

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Introduction

Since independence, Pakistan can look back on fifty years of steady, sometimes spectacular economic advance. Pakistan's growth has been the fastest in South Asia. The gross national product has increased on average by over 5 per cent a year since 1947. Pakistan started behind India at the time of independence, but its income per capita is now 75 per cent higher. In spite of high population growth, per capita income has more than trebled in the past two decades.

Still, despite these accomplishments there is growing dissatisfaction with the country's economic performance. Here the main shortcomings often cited include: (a) large budgetary and balance of payments deficits, (b) increasing inflationary pressures, (c) population explosion and rising unemployment, (d) physical infrastructural constraints, and (e) inadequate human resource development.[1]

Pakistan's golden jubilee presents an opportune time to examine the country's economic performance during the last fifty years. How far has the economy progressed and at what cost? Is progress sustainable? What are the main limitations associated with the country's development model? Is Pakistan on the verge of becoming an Asian Tiger? Ultimately, one has to address the question posed by Mahbubul Haq 'Why are its

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people so poor when the economy has made such rapid progress?'[2] Perhaps a related question is whether and to what extent democracy can be sustained in light of the massive economic and social difficulties the country currently faces.[3]

Overview

Pakistan's economic history is a classic case of half empty or half full. The Gross National Product (GNP) and per capita income have increased substantially during the last fifty years. Between 1960 and 1980, Pakistan's real GNP increased by 250 per cent. This translates into an average annual increase of 4.07 per cent. Again, between 1980 and 1997 Pakistan's Real GNP went up by 179 per cent or an average annual increase of 5.88 per cent. Thus, the country's GNP increased in real terms by about 430 per cent during the period averaging 4.77 per cent. However, real GNP per capita increased only by about 125 per cent due to the massive increase in the country's population from 43 million in 1960 to approximately 135 million in 1997.

The marked increase in Pakistan's GNP during the last fifty years was made possible through substantial increase in agricultural and industrial output.[4] Production of all the major agricultural crops registered impressive increases during the last five decades. Production of wheat went up from 3.9 million tons in 1960 to 16.4 million in 1997. Production of rice rose from about one million tons in 1960 to an estimated 4.3 million in 1997. Production of cotton moved up from 1.7 billion bales to 9.4 billion, while production of sugarcane increased from 10.7 million tons to 42 million tons during the above period.

As far as the manufacturing sector is concerned, Pakistan started almost from scratch. At the time of establishment of Pakistan, there were only one or two textile mills and cement plants in the country. During the last fifty years, not only have hundreds of textile mills been established, but food industries including vegetable ghee and sugar mills, cigarette manufacturing units, cement plants, and fertilizer factories have

also been established in the country. The production of vegetable ghee rose from 17,000 tons in 1956 to 717,000 tons in 1997. Production of sugar went up from 81,000 tons in 1956 to about 2.5 million tons in 1997, whereas, production of cement increased from 732,000 tons in 1956 to 9.6 million tons in 1997.

Apart from the above-mentioned industries of a basic nature, Pakistan is entering the era of engineering and automotive industry, electrical and mechanical goods industry, steel, shipbuilding, and pharmaceutical industry. Presently, the manufacturing sector accounts a share of 18 per cent in the country's Gross Domestic Product (GDP) and this share may go up further when the engineering, automobile and other value added industries make a headway in the coming years.

For many, the increase in Pakistan's GNP and per capita income resulting from the development of the country's agricultural and manufacturing sectors translates into improved living standards. The number of motor cars, jeeps and station wagons registered in Pakistan increased from 15,849 in 1950 to 923,577 in 1995. The number of telephone connections went up from 60,000 in 1960 to 2.4 million in 1997, whereas the availability of television sets increased from 92,000 in 1970 to 2.7 million in 1996.

On the negative side, it is clear that the country has achieved too little and what has been accomplished has been done at a very high cost. Despite the substantial increase in the production of major agricultural crops, the country has still not been able to achieve food self-sufficiency and has to spend about $2 billion annually on the import of wheat, edible oil, and the like. As far as manufacturing is concerned, the country has yet to make a real breakthrough in engineering and other value added industries and is heavily dependent on imports to meet its requirements of machinery, electrical and mechanical goods, transport equipment, steel, and chemicals.

It is due to this fact that Pakistan's annual imports ($11.5 to $12 billion) exceed its annual exports (8.5 billion on average) by about $3 billion to 4 or 3.5 billion. As a result, Pakistan's

external debt has mounted to an alarming $32 billion and in addition there is an internal debt of Rs 1000 billion. Because of such a heavy debt liability, the allocation for debt servicing alone (Rs 249 billion) in the federal budget for 1997-98 constituted nearly 45 per cent of the total outlay and the government had to cut down on its vital defence and development budgets in real terms.

Unfortunately, it seems that after fifty years of independence and economic planning, the country's fortunes still depend in a large part on the country's cotton crop. More than half of the country's exports still consist of cotton products, mainly textiles and related materials. In the past three years, successive crop failures have increased the price of cotton in the domestic market and eroded the profits of the textiles sector. Export growth has been slow and both the international trade and current account deficits have swelled.

Even more importantly, the country has failed to develop its human capital. In this regard Pakistan's economic growth is a puzzle because there is scant evidence that this economic advance has affected the lives of ordinary people. Indices of poverty and deprivation are so widespread and so stark that many sceptics have begun to doubt the reality of economic growth itself. The simple explanation is in fact that growth has taken place but the prosperity it has produced has been very unevenly distributed.

- In 1960 about 19 million people lived below the poverty line in Pakistan. By 1980 the number of people defined by the government as absolutely poor had grown to 34 million.
- Poverty then fell by 10 million during the 1980s thanks to a bonanza of external remittances, largely from Pakistani workers in the Middle East.
- But poverty has started increasing again alarmingly. In just five years between 1990 and 1995 the number of absolute poor rose from 24 million to 42 million.[5]

Summing up, the country appears to be at the crossroads. The predicament facing the government at the moment is that it can neither repay all of its debt and get out of the debt trap nor is it left with enough money after making budget allocations for defence and debt servicing so as to spend on the development of the physical and social infrastructure.

The present Government is trying hard to retire part of the external and internal debt by speeding up its privatization programme. Simultaneously, the authorities have announced an economic reform package to boost the GDP growth rate and exports in the shortest possible time. One thing is clear. Whether the country will be able to revive its growth and retain the hope of becoming an Asian Tiger will depend largely on the goodwill of the International Monetary Fund and the country's major creditors.

Patterns of Economic Growth and Development

To gain a sense of how the country got in its current predicament, the following sections trace the economic history of the country. In particular, we are interested in determining the factors that appear to have been responsible for periods of high growth as well as those associated with periods of relative decline. Based on this analysis, several scenarios are developed for the period up to the year 2000.

Pre-Ayub Years (1947-57)

Pakistan's initial economic conditions could not have been much less favourable for supporting rapid economic growth and development. The parts of India that became Pakistan in 1947 were for the most part the outlying areas situated on the boundaries of the subcontinent. No real industries existed. The major sources of wealth were the Jute Crop in East Pakistan and Cotton in the Punjab. Agrarian relations in the Punjab were predominantly feudal, with tenant cultivators tilling the land, while land ownership resided with big landlords who exercised

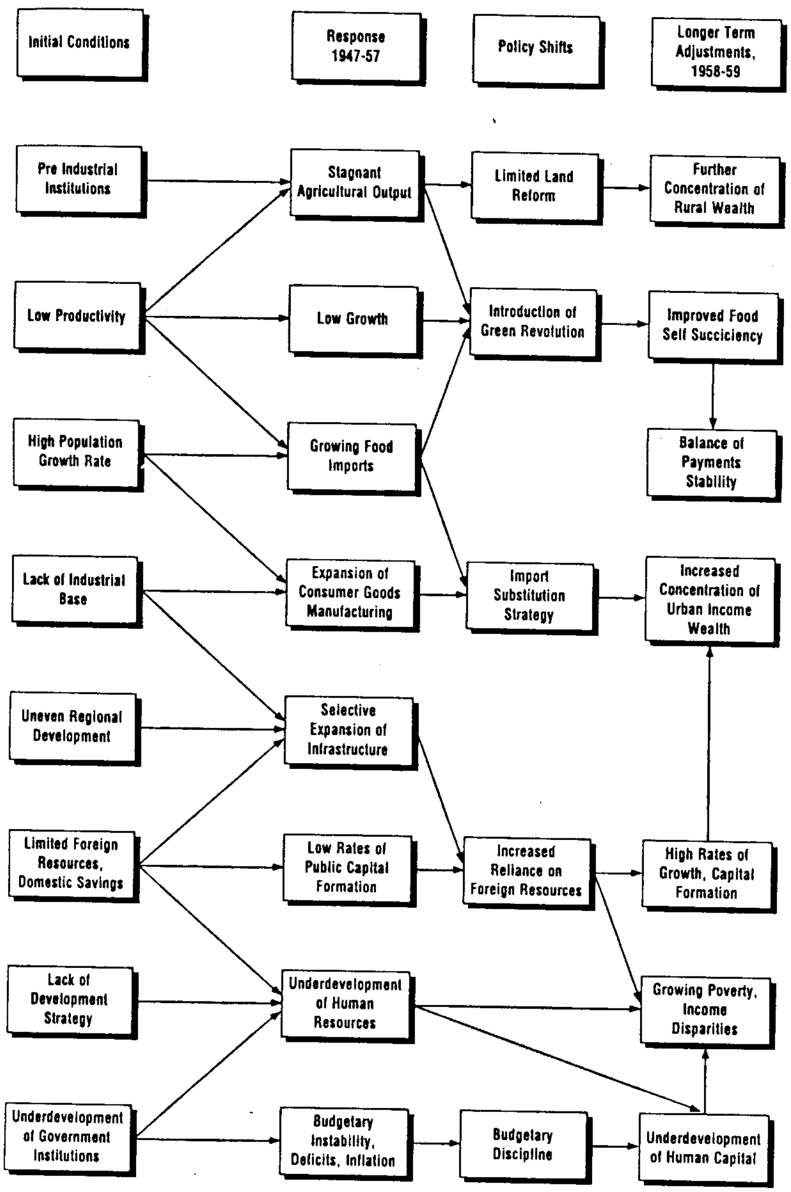
complete social domination in their estates. Both the system of land tenure and the level of agricultural technology worked against productivity. Thus, the fertile plains of the Punjab could hardly produce surpluses large enough to aid in the establishment of an industrial base. In fact the main source of surplus for investment for the new state was the jute crop in the East. During the fifties the export of raw jute provided the major source of foreign exchange earnings for Pakistan. In sum Pakistan began its economic development in an environment of:

- Pre-industrial institutions
- Low productivity
- Non-existence of an established manufacturing industry
- Uneven regional development
- High population growth.[6]

Despite these limitations, several key economic developments took place (Fig. 1) during this period:

- The most notable economic accomplishment was the rapid expansion of large-scale manufacturing. Although the average growth rate of 19.1 per cent per annum must be interpreted with caution because of the very small base from which the economy started, the achievements in the manufacturing sector were impressive and laid the foundation of a consumer goods industry. However there was a significant slowing down in growth during the last three years—1955 to 1957.
- Throughout the period the dominant sector of the economy, agriculture, stagnated, and its growth was in fact even less than the growth in population, so that the per capita consumption of food grain declined and in many cases had to be supplemented through food imports.
- Because of little growth in the agricultural sector, the small share of manufacturing and the high growth rate of the population, the overall per capita income did not increase during this period.

Figure 1
Pakistan, Patterns of Growth and Collapse, 1947-1969



- There were, however, other important achievements which tend to be overlooked. The settlement of seven million refugees, the setting up of the administrative machinery of government, the establishment of vital economic institutions like the State Bank, and other financial institutions were all achieved with considerable success during this period.[7]

An examination of the patterns of public and private investment does reveal the initial development of what were to become several of the country's long-term development priorities:

- Investment in the industrial sector dominated the private sector investment.
- Investment in the agricultural sector was minimal compared with that in industry.
- Significant improvements were made in infrastructure development especially in the transport and communication sector. There was also substantial private sector investment in housing which was undertaken mainly by the higher income groups.
- Investment in the social sectors, i.e., education and health, were minimal and these sectors had a very low priority in the total development expenditure.[8]

Ayub Administration (1958-69)
This was a period of rapid economic growth averaging 5.4 per cent annually. Given the rate of population growth this translated into an increase of per capita incomes of 3.5 per cent. Large-scale manufacturing grew at almost 17 per cent annually. During this period, the Green Revolution provided a major stimulus to the agricultural sector.

There is considerable controversy regarding overall economic performance during this period.[9] For some, the sixties were a time of considerable economic success. Those who take this position usually point to various economic indicators to prove their case. Their usual defence is that the resulting economic

problems and tensions were either exaggerated or were a 'cost' one had to bear for rapid economic development.

For others, the growth performance was exaggerated. Even worse, they argue, this period of rapid economic growth generated a great deal of economic tensions: Regional and class inequalities increased, while large segments of the population experienced falling standard of living. The concentration of incomes was particularly disturbing.[10] Twenty-two families owned 66 per cent of industry, 97 per cent of the insurance sector, and 80 per cent of banking. Only 0.1 per cent of landlords owned 500 acres or more, yet they owned 15 per cent of the country's total land.

While the matter is controversial there is no doubt these patterns contributed to the social and political unrest which, in the winter of 1968, led to the downfall of Ayub's government. On the other hand, there is general agreement that this period in the country's economic history was characterized by sound economic management. In contrast to the fifties and seventies, the economy was subject to some kind of overall economic discipline within the frameworks provide by the Second and Third Five-Year plans. There was considerable monetary discipline and budget deficits were kept at a minimum. There was overall price stability, although several years did have relatively steep increases in price. Significant steps were taken to increase exports and in the case of manufactured goods, there were substantial gains. The government machinery of economic controls over prices, imports, and industrial investment were steadily dismantled and greater use was made of market forces.

Bhutto Administration (1972-77)

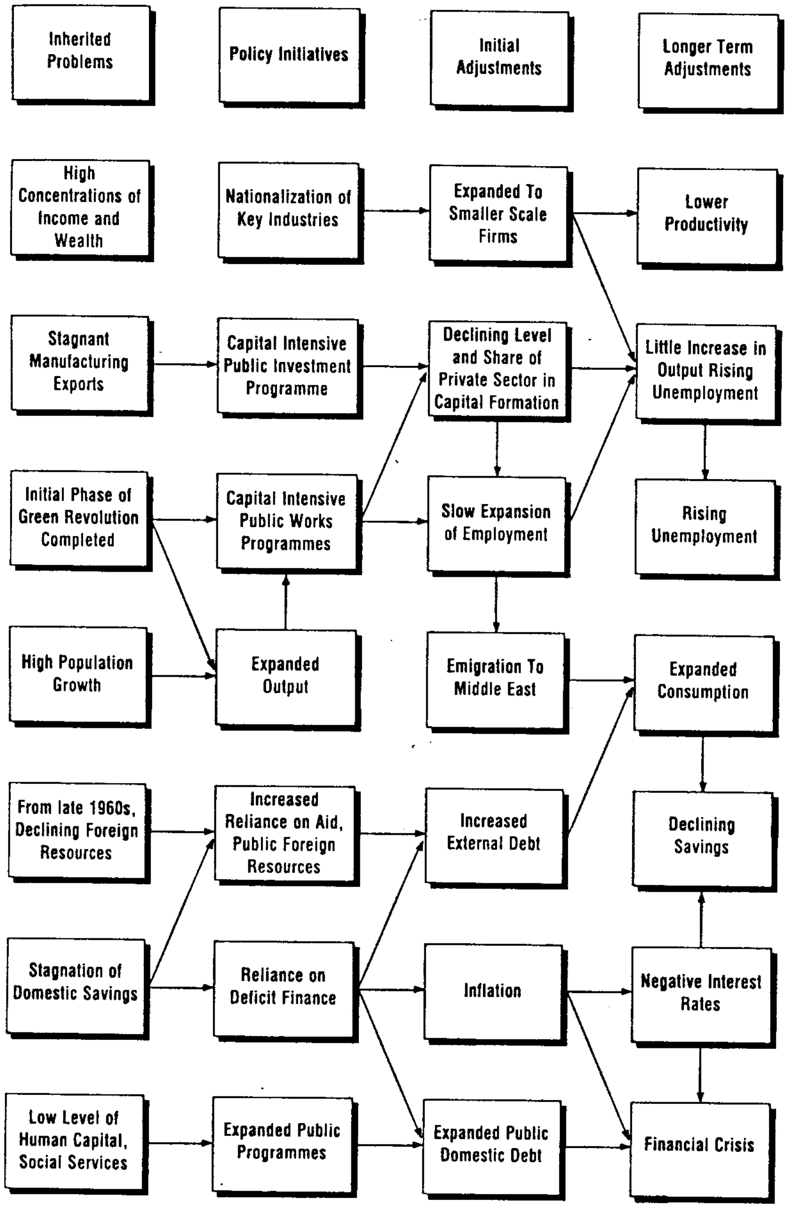
The regime of Zufikar Ali Bhutto was given the mandate to eradicate the class structures that economic growth had produced. Economic growth during this period was 4.3 per cent per year. Large-scale manufacturing declined substantially growing at a rate of less than 3 per cent annually compared with growth rates that exceeded 10 per cent in the 1960s. There was a decline in per capita agricultural production. Industry and

educational institutions were nationalized, the efficiency of industry declined and people became disenchanted with the economy. The main events of this period are outlined in Figure 2.

This period represents a marked shift in the country's pattern of savings and investment.

- During the fifties the level of investment had been low and its peak in 1954-5 was only around 8 per cent of Gross Domestic Product. It had, however, increased considerably over the earlier years of the fifties when it had started from a low of 4.6 per cent.
- Investment was mainly undertaken by the private sector with the public sector contributing only about 30 per cent to the total fixed investment in 1954-5.
- In the earlier years of the fifties almost all of the investment was financed by domestic savings and in 1954-5 foreign resource flows were only one per cent of GNP.
- In the Ayub years the situation changed dramatically with an almost doubling of the investment level between 1959-60 and 1964-5. Coinciding with this increase was a large inflow of foreign resources. These increased from 5.4 per cent of the GNP in 1959-60 to 8.9 per cent in 1964-5.
- Gross Domestic savings also experienced a substantial increase from 6.0 to 12.2 per cent of GNP.
- After 1964-5 the level of investment began to decline and it was 15.6 per cent in 1969-70 compared to 21.2 per cent in 1964-5. This was also associated with a substantial decline in foreign resource inflows which, by the end of the sixties, were only 3.1 per cent of the Gross National Product.
- Gross Domestic savings stagnated at the same level as in 1964-5.
- The division between public and private investment increased substantially in favour of the private sector whose share in the total investment increased from 38.8 per cent in 1959-60 to over 50 per cent in the sixties.

Figure 2
Pakistan, Transition Policies Under Z.A. Bhutto, 1972-1977



- The decline in the level of gross fixed investment, which had started in the late sixties continued in the early seventies until about 1972-3 after which it began to improve. By 1976-7 it had reached 17.7 per cent of GDP.
- The increase in investment also coincided as it had done in the sixties with large increases in foreign resource inflows which were now at a higher level than they had been in the 1960s, averaging about 10 per cent of GNP.
- The important difference between the sixties and the seventies: the share of private investment in total investment declined drastically and in the seventies, public investment contributed about 70 per cent of the total. The situation was now almost the reverse of what it had been in the fifties.

Summing up this period is difficult, but several main failure patterns stand out:

- The administration's economic and social development programmes were over-ambitious with costs far exceeding the availability of domestic and foreign resources. By relying on deficit financing to meet the country's resource gap and by furthering inflation it squeezed the middle classes and they finally revolted against the regime.
- Critical to success of the government's strategy was the achievement of high growth rates of agriculture and industry to cushion the long gestation of public sector programmes. The failures of these sectors meant that there was very little growth of output from 1974-5 to 1976-7.
- The government's programmes failed to generate much employment because the bulk of investment was in capital-intensive projects. However the employment situation was considerably improved by the large-scale emigration of the industrial labour force to the Middle East.
- The government failed to establish the ideology of state capitalism which it had initiated through the process of nationalization. It failed to establish a working relationship with the big monopoly houses which refused to invest throughout the period and preferred to invest abroad.

- The government exceeded its original policy of nationalization and began to nationalize industries other than those which had originally motivated the reform. This was especially true of the smaller units in the agro-based industries.[11]

The result of the lack of private capital formation during this period was that the economy became caught in a double squeeze. High oil prices and increase in remittances from workers abroad led to inflationary pressures and with the private sector not investing, more funds were diverted towards consumption which further increased the demand pressures on the economy.

Zia Administration (1977-88)

As Burki has observed, an interesting pattern that emerges when one looks at the economy is that Pakistan has generally not been in step with the other developing economies.[12] This suggests that economic policy rather than external environment has played a much more significant role in shaping the course of development. Successive governments seldom pursued the same set of objectives and seldom emphasized the same sectors of the economy. Consequently, there were sharp fluctuations in sectoral fortunes. Light manufacturing was the sector favoured by the governments of the early 1950s, to be replaced by agriculture in the 1960s.

Although the Bhutto government was interested in increasing output, neither agriculture nor industry received sufficient attention to meet that objective. In the concluding years of the 1970s and early 1980s the government turned its attention once again to the development of the agricultural sector with a subsequent improvement in that sector's fortunes (see table 1). In general:

- Pakistan has a service sector that is relatively large given its income and an industrial sector that is underdeveloped for its stage of development.

- With regards to demand, as noted, the country's levels of savings and investment are considerably below the norm for low-income countries.
- While public consumption and exports are more or less in line with countries of similar income levels, private consumption is considerably above the average for this group.

Economic growth accelerated under Zia. The average annual GDP growth rate was 6.3 per cent during 1978-83. The manufacturing growth rate was 9 per cent, substantially above the 3.8 per cent average during 1972-8. All sectors except services and construction showed improved growth performance and from 1982-8 the economy grew at an even better pace: the GDP at an annual rate of 6.6 per cent and large-scale manufacturing at an average annual rate of 16.6 per cent. The economy clearly started to revitalize after the Bhutto government was overthrown.

Another economically and politically significant event was the flow of people to West Asia to find jobs. Approximately ten million people, 11 per cent of the total population benefited directly from this exodus. Rough estimates are that from 1975 to 1985, Pakistan received a total of $25 billion in remittances from the workers in the Middle East, a good proportion of which went to the poorer segments of the population.[13]

Another cause of the impressive growth during the Zia era was the large amount of foreign assistance coming to Pakistan in connection with the Soviet invasion of Afghanistan. Assistance from the United States after 1982 totaled around $5 billion, making Pakistan the third largest recipient of US aid in the 1980s.

Perhaps because of the acceleration in capital inflows the government did not pursue any major initiatives in promoting exports. Instead, the high level of imports was fueled largely by the fortuitous increase in remittances and foreign aid.

Table 1
Comparative Evolution of the Structure of the Pakistani Economy

	1960	1965	1980	1990	1995
Composition of Output					
Agriculture					
Pakistan	46	40	30	26	26
Low Income	49	41	34	31	25
Middle Income	24	19	15	12	11
Industry					
Pakistan	16	20	15	25	24
Low Income	26	26	35	36	38
Middle Income	30	34	40	37	35
Services					
Pakistan	38	40	44	49	50
Low Income	25	32	29	35	35
Middle Income	46	46	45	50	52
Structure of Demand					
Public Consumption					
Pakistan	11	11	11	15	12
Low Income	8	9	11	11	12
Middle Income	11	11	14	14	14
Private Consumption					
Pakistan	84	76	83	73	73
Low Income	78	74	68	61	59
Middle Income	70	67	64	62	59
Gross Domestic Investment					
Pakistan	12	21	18	19	19
Low Income	19	19	25	31	32
Middle Income	20	21	27	23	25
Gross Domestic Savings					
Pakistan	5	13	6	12	16
Low Income	18	18	22	28	30
Middle Income	19	22	25	24	25
Exports					
Pakistan	8	8	13	16	16
Low Income	7	8	9	18	19
Middle Income	17	17	25	28	24

Source: World Bank, World Development Report, various issues.

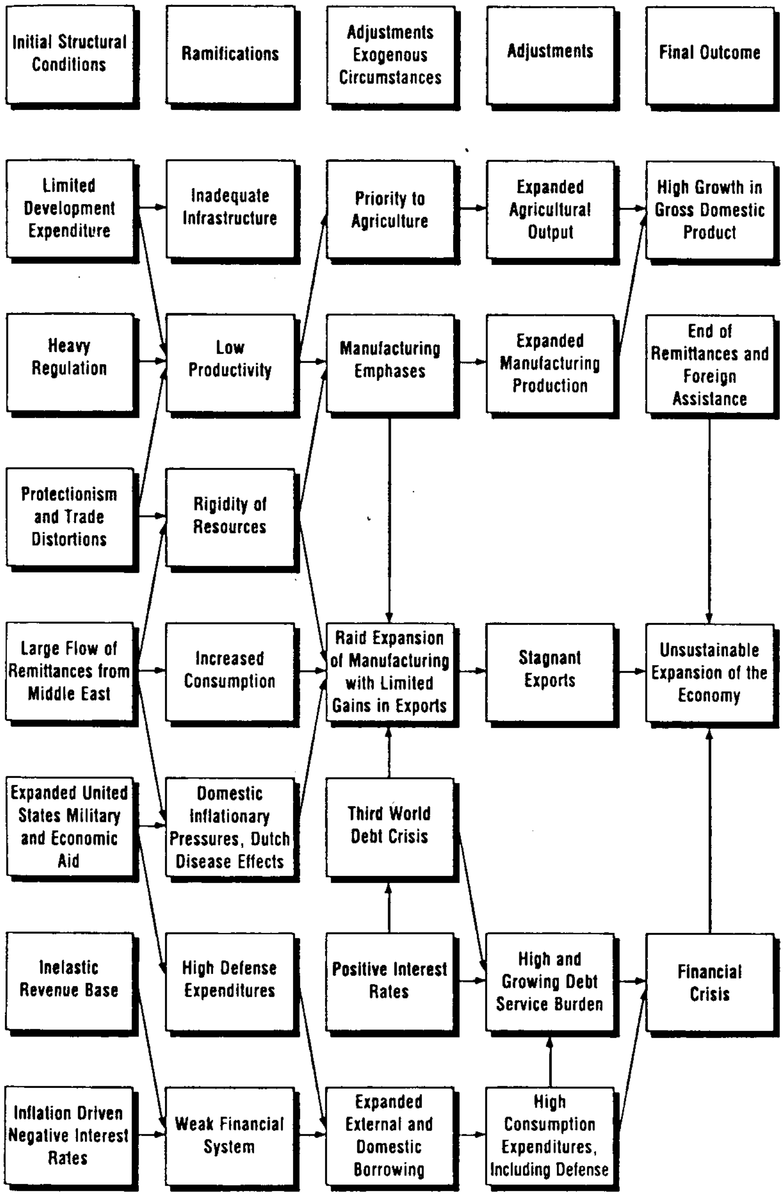
All in all, however, the eleven years of General Zia's rule represent an extraordinary missed economic opportunity (Figure 3). Just when generous levels of western aid were forthcoming, inflows of remittances from overseas Pakistani workers were also peaking. Between 1975 and 1985 Pakistan received $25 billion in remittances. Failure of the government to mobilize and direct a large share of these funds into infrastructure investment and improvements in education and health care meant that a unique set of fortuitous factors yielded to durable economic dividends. Lack of investment in the infrastructure in rapidly growing cities like Karachi sowed the seeds for crime, violence and ethnic tensions.[14]

Despite its rapid growth the economy showed an increasing number of structural weaknesses toward the end of the Zia Administration. These included: (1) heavy regulation of economic activity through price control, industrial licensing, and Government ownership; (2) a trade regime that provided a high level of protection and created distortions, thus inhibiting competitiveness and export growth; (3) a weak public resource position due to a narrow and inelastic revenue base, high consumption expenditure, particularly defence, and inadequate development expenditure, resulting in an excessive budget deficit; (4) an inefficient financial sector with mostly public ownership, directed credit, and weak commercial banks; and (5) a high and growing debt service burden resulting from the country's heavy reliance on external borrowing to finance its economic growth in the 1980s.

The main reason many of these problems did not come to a head until the late 1980s was that the real interest rates on both external and domestic debt were substantially negative during the 1970s. Mainly because of this factor, debt to GDP ratios continued to decline even though Pakistan ran substantial fiscal and current account deficits in the 1970s.[15]

However, real interest rates began turning positive during the 1980s. This development had an adverse impact on Pakistan's debt situation. Consequently, the interest burden of the domestic and external debt began increasing significantly in the 1980s into the 1990s.

Figure 3
Pakistan's Economy Under Zia (1977-1988)



The Post-Zia Years

In this setting of runaway deficits and a resource crunch, democracy was re-born after General Zia's death in a plane crash in 1988. The return to an uncharted democracy coincided with the end of the cold war and the resultant diminution of Pakistan's strategic value in the eyes of its allies. Compounding the adjustment was the suspension in the 1990s of US military and economic aid on the grounds of Pakistan's continued pursuit of nuclear capability to match India's.[16] In a 1991 study, Khiliji and Zampelli anticipated that the termination of US assistance would significantly reduce private consumption and investment opportunities thus affecting adversely the country's standard of living and private capital formation.[17] Their forecasts have been largely borne out (Figure 4).

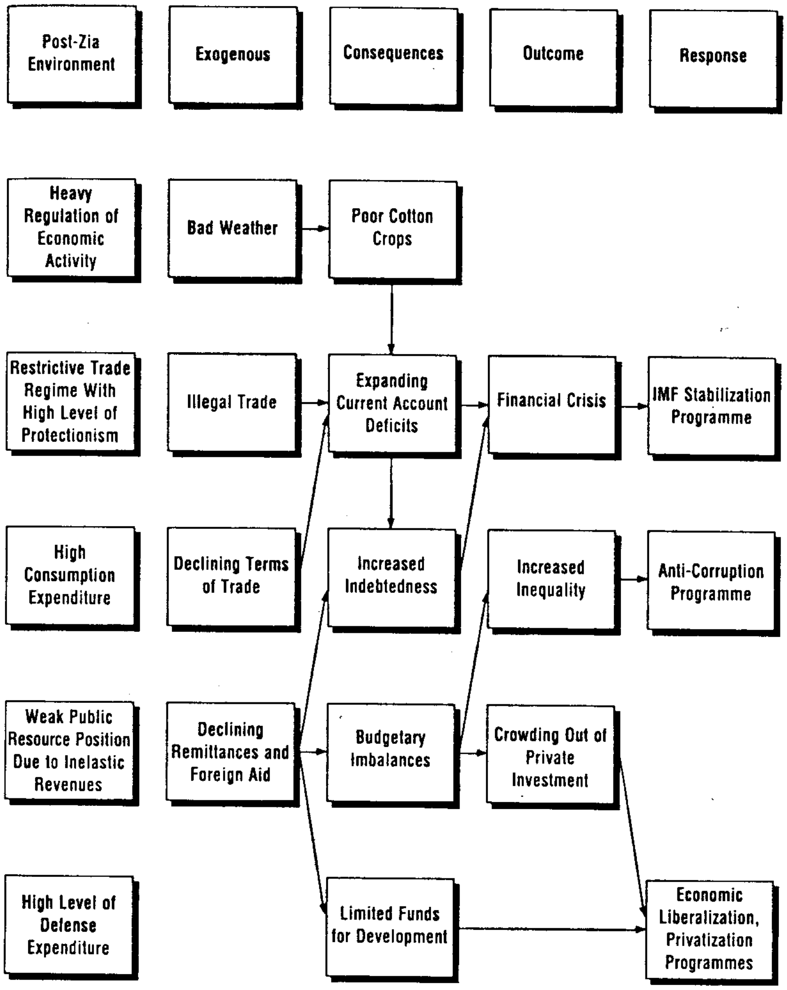
As an aftermath of the continuing resource scarcities that began to plague the country in the late 1980s, the government entered into agreements with the World Bank in the early 1980s and the IMF in the later part of the decade. The major emphasis of these agreements rested on the correction of prices and deregulation of trade. However latter agreements became all-inclusive as they involved structural and fiscal reform for deficit reduction, extensive trade liberalization and policy measures for reducing price distortions, deregulating production and investment for promoting efficiency of the system.[18]

Adjusting to new global realities while coping with the country's legacy of living beyond its means was not easy. For both Benazir Bhutto and Nawaz Sharif, a daunting challenge has been to deal with the political consequences of undertaking austerity.

The Benazir Bhutto Government (1988-90)

The first Benazir Bhutto government was of the democratic-distributive kind, emphasizing the socio-economic aspects of democracy. Unlike her father's policies of nationalization and public sector expansion, Benazir attempted to bring the private sector to the forefront of economy in Pakistan.[19] The economy, however, proved difficult to stimulate. The Bhutto Administration

Figure 4
Pakistan's Economy Under Zia (1977-1988)



inherited a deal negotiated by the Zia regime in accordance with economy-restricting guidelines under which Pakistan received \$1.169 billion from the IMF and World Bank.

Toward the end of the 1988 financial year, the deteriorating resources position caused a financial crisis. The budget deficit reached 8.5 per cent of GDP, inflation accelerated, the current account deficit doubled to 4.3 per cent of GNP, the external debt service ratio reached 28 per cent of export earnings, and foreign exchange reserves fell in half to \$438 million, equal to less than three weeks of imports.

The economy's performance during this period was largely constrained by the crisis it had inherited. The macro-economic performance during 1989-90 was slow and uneven. In 1989, the Government implemented the measures envisaged mostly on schedule and achieved improvements in a number of macroeconomic indicators. However, exogenous shocks, in particular floods and a deterioration in the country's terms of trade took their toll and required an extension of the target date for the completion of the programme. In 1990, serious slippages occurred in implementing reform measures in the financial sector, in containing liquidity growth, and in fiscal policy. As a result, the reform programme was substantially off-track at the end of the second year.

Nawaz Sharif Administration (1990-93)

The Sharif administration's primary interest was in the economy. However, growth declined somewhat from the Zia years, averaging at 4.9 per cent during the 1990-1994 period. Privatization and increased exports were the primary focus of the government with a fairly dramatic shift in output towards the export sector. Under this administration numerous measures were enacted to expedite the pace of growth through privatization. Sharif privatized some government institutions by providing incentives to foreign investment. His reforms opened several industries to private enterprise and his government offered liberal tax and tariff incentives to new industries.[20] It also liberalized foreign exchange, opened export trade to foreign

firms, and returned almost all industrial units and financial institutions to the private sector.[21]

In large part, the economy slowed down because foreign channels of funding had gradually dried up. Foreign aid dwindled in the post-cold war era and remittances from expatriate Pakistanis fell as the Gulf boom of the 1970s and eighties came to an end. Unfortunately, private foreign direct investment has not picked up the slack. The strategy of Sharif's government has been to offset this reality with the potential for economic stimulus, often linked to the increased economic freedom associated with his reform programme.

Clearly, this approach is consistent with the growing literature stressing the association between economic freedom and economic performance. For example in *Economic Freedom of the World, 1975-1995* Gwartney, Lawson, and Block show a strong direct connection between economic freedom and economic well-being.[22] From the standpoint of basic economic theory, this result is entirely understandable: restrictions on economic freedom cause inefficiency and result in sub-optimal levels of utility, personal income and the like.

A short, reasonably accurate definition of economic freedom is that it exists when persons and their rightfully-owned property (that is 'thing' acquired without the use of force, fraud, or theft) are protected from assault by others. An individual's private ownership right includes the right to trade or give rightfully acquired property to another. It is asserted throughout by Gwartney *et al.* that protection from invasion by others and freedom of exchange are the cornerstone of economic freedom. Economic freedom can thus be distinguished from political freedom which focuses on political and civil liberties.

For our purposes, the main issues are: What gains have been made to date and in what areas? How has progress in the country compared to that attained in other parts of the world? What are the implications for the country's future growth?[23]

In the Gwartney study, 102 countries were rated on each of the main areas of economic freedom on a scale of 0-10, in which zero means that a country is completely unfree and ten

means it is completely free. Such scores were given for 1974, 1980, 1985, 1990 and 1993-5 (depending on the latest figures available).

Having obtained such ratings, however, a major problem remains in the construction of some sort of aggregate summary index. Do all of the measures matter equally? Any method is inherently arbitrary. The authors used three methods: (1) with each component having an equal impact (Ie); (2) with weights determined by a survey (Is1) of 'knowledgeable people', defined as economists familiar with the problem; and (3) with weights derived from a survey (Is2) of experts on specific countries.

While Gwartney *et al.* feel (2) above is the best measure, one can easily make the case that a more objective measure might provide additional, if not necessary superior insights. The factor analysis developed below is one such measures. Using the three summary measures, together with the four broad components of economic freedom one can trace Pakistan's progress in recent years (Table 2).

Pakistan's summary economic freedom rating (Is1) improved from a very low 2.3 in 1975 to 5.4 in 1993-5. Most of the improvement came in the 1990s. In terms of the ranking, Pakistan moved from 93rd in 1975 to 50th in the mid-1990s. The improvement in the country's economic freedom rating can be attributed to a few components in the index. First, top marginal tax rates have been reduced from 61 per cent in 1975 (and 60 per cent in 1985) to the current 38 per cent. A significant liberalization of the exchange-rate system has reduced the black market exchange rate premium from a high of 27 per cent in 1980 to zero (and a rating of 10) in 1993-94. Some of the increase in the summary rating for 1993-95 may reflect the fact that the Taxes on International Trade (Iva) datum was not available for Pakistan in that year. In all the previous periods, this component received a zero rating. Its absence in the most recent period may have artificially inflated the summary rating slightly.

Table 2
Pakistan: Economic Freedom Ratings, Components and Summary Indexes

Components of Economic Freedom	1975	1980	1985	1990	1993-5
Money and Inflation	**1.9**	**3.6**	**4.8**	**6.1**	**5.8**
1. Annual Money Growth (last 5 years)	4	2	7	5	5
2. Inflation Variability (last 5 years)	2	9	8	8	7
3. Ownership of Foreign Currency	0	0	0	10	10
4. Maint. of Bank Account Abroad	0	0	0	0	0
Government Operations	**4.9**	**5.2**	**5.2**	**4.8**	**4.6**
1. Government Consumption (%GDP)	8	8	7	5	7
2. Government Enterprises	2	2	2	4	4
3. Price Controls	–	–	–	–	4
4. Entry into Business	–	–	–	–	5
5. Legal System	–	–	–	–	0
6. Avoidance of Neg. Interest Rates	–	6	8	6	8
Taking	**0.8**	**3.8**	**3.0**	**4.5**	**6.1**
Transfers and Subsidies (%GDP)	.	.	.	.	.
Marginal Tax Rates (Top Rate)	1	2	1	3	5
Conscription	0	10	10	10	10
International Sector	**2.3**	**2.0**	**3.0**	**2.3**	**6.1**
Taxes on International Trade (Avg.)	0	0	0	0	.
Black Market Exchange Rates (Prem.)	4	3	6	4	10
Size of Trade Sector (%GDP)	4	4	5	4	6
Capital Transactions with Foreigners	2	2	2	2	2
Summary Ratings					
Ie	2.4	3.6	4.2	4.5	5.3
Is1	2.3	3.5	3.9	4.2	5.4
Is2	1.9	3.2	4	4.3	5.0

Source: Gwartney, 1996, p. 186.

Summing up, it is clear there has been a slight move toward economic liberalization in Pakistan over the last two decades. This improvement has allowed Pakistan to report modest, if unremarkable, annual growth of per capita GDP of approximately 2.5 per cent. For Pakistan to make the move into the modern market economy like Malaysia, Thailand, and Singapore, it must improve its regulatory environment that restricts citizens from holding bank accounts abroad, restricts prices and market entry, fails to treat equally before the law, and interferes with the capital transactions with foreigners.

As noted above, this theory suggests that a sustained increase in economic freedom will enhance growth, while a decline will retard it. Thus one would expect countries with an expanding amount of economic freedom to have high growth rates than those with a contracting amount of freedom. However, as Gwartney and associates stress, the immediate impact of a change in economic freedom is likely to be small.[24] The reason is simple, there will be a large gap between the time when institutional arrangements and policies become more consistent with economic freedom and when they begin to exert their primary impact on economic growth. Clearly, however, through economic reform, the government is laying the foundation for the restoration of strong economic expansion.

Benazir Bhutto (1994-97)

Benazir Bhutto's second administration took office in October 1993. That government continued and reinforced the country's economic reform programme. The second Bhutto administration has been widely criticized for mismanagement of the economy.[25] Until her last week in office, she refused to name a finance minister, keeping the crucial powers of the purse for herself and her husband. She relied on an economic aide whose economic data proved so unreliable that, just before Ms Bhutto fell, the International Monetary Fund threatened to walk out of emergency loan talks with Pakistan unless he was replaced. Without a credible economic team, Ms Bhutto ran up huge budget deficits, inflation soared, and the IMF halted its loans to

the country. There was general fear that the economy was collapsing.

In the weeks before Ms Bhutto's ouster, Pakistan's foreign exchange reserves fell to just $600 million, or less than the cost of three weeks' imports. At the same time, the country was facing debt repayments of some $900 million in the latter part of 1996, a burden it couldn't possibly bear without fresh loans from foreign banks.

Nawaz Sharif (1997-99)

At the time Nawaz Sharif assumed power for the second time, Pakistan's economy had seldom before faced such a gloomy outlook. At the start of the new financial year in July, many analysts were forecasting that the country would for the first time default on its $39 billion foreign debt (largely due in December). Unexpected help from the IMF has averted that crisis, but the need for expanding and accelerating the reform programme remains urgent:[26]

- Servicing the burden of foreign and domestic debt during the current financial year (1997-8) is expected to absorb more than 40 per cent of budgetary expenditure, the largest proportion ever devoted to debt servicing.
- An increasingly heavy debt burden has hardly been helped by meager economic growth. For the year ending in June 1996, the economy grew by only 3.1 per cent. In a country where annual population growth is at least 3 per cent, that effectively amounts to a standstill.
- Other economic indicators were also bad. Large-scale manufacturing contracted for the first time in over fifty years, while agriculture, which is the backbone of the economy and responsible for almost a quarter of GDP, grew only 0.7 per cent.
- Pakistan's worsening international trade performance is among the most visible symbols of its economic malaise. The trade deficit for the year that ended in June hit a record high of $3.37 billion, up from $3.1 billion the previous year.

Yet the government has slashed personal taxes from a range of 10 to 35 per cent to one of 5 to 20 per cent and announced reductions of between 3 and 8 per cent in corporate tax rates. The measures have been accompanied by cuts in imports tariffs of up to 20 per cent lowering the top rate to 45 per cent. The cuts are part of Nawaz Sharif's strategy to encourage more people to pay taxes. Inadequate systems of collection and inspection mean that currently only one million Pakistanis—less than one per cent of the 130 million population are tax payers.

Many businessmen have acclaimed the tax cuts on the grounds that they will help to improve Pakistan's investment climate and restore a battered confidence in the country. Mr Sharif's reforms are beginning to pay off with help from the IMF, which is in the process of considering a request for $1.6 billion medium-term loan due for disbursement over the next three years.

Pakistan desperately needs the Fund's support to overcome its short-term debt repayment crunch. With foreign banks taking the lead from an IMF programme and offering new credits in Pakistan, Mr Sharif would then be able to survive the tough year head. Sharif hopes to use such a window of opportunity to launch some of the biggest economic changes ever undertaken in Pakistan, including large-scale reform and privatization of the public sector. In addition, exporters have also been offered a number of incentives. This is a high-risk strategy that will most likely encounter a number of difficulties, most notably the risk that government revenues will fall short of expectations in spite of the tax breaks. The IMF has been promised a budget deficit of 5 per cent of GDP this year, down 6.1 per cent from last year. But many argue that large scale tax evasion is a deep rooted cultural problem in Pakistan and it is unrealisitc to expect an end to this phenomenon.[27]

On the other hand, the country's recent tax reforms may help to reduce the size of the underground or 'black economy' hence improving tax collection. In Pakistan's case the black economy consists of:

- The Illegal Economy: This consists of economic activities which are anti-social in nature. Here the most common type of underground activity is drug trafficking.
- The Unreported Economy: The unreported economy comprises those activities that circumvent or evade the payment of taxes. It includes income which should be reported to the authorities but is not.
- The Unrecorded Economy: This area includes those activities which are concerned with the problems relating to the rules and regulations of the reporting requirements of statistical agencies. It includes that income which should be recorded in the national accounts but is not included.
- The Informal Economy: This comprises those activities that entail a cost but are excluded from the benefits and rights of the formal activities. They are illegal but not anti-social.[28]

Ahmed's findings suggest that the share of the black economy was high during the sixties and eighties which can be attributed to high taxes and regulations imposed by the government. In the late eighties the black economy had started to fall mainly because of the lowering of direct taxes (personal income tax and the corporate tax) levied. However, the black economy still stands at about one-third of the GDP. Ahmed estimates that the revenue loss due to the presence of the black economy was between Rs40 to Rs45 billion in 1989-90. The implication is that substantial revenue gains can be realized by reducing the extent of tax evasion in the economy.

The illicit flow of consumer goods across Pakistan's leaky borders—chiefly from Afghanistan, has already ruined some domestic manufacturing industries. Industrialists say smuggling is a strong contributor to Pakistan's poor recent economic performance. Foreign direct investment in 1996, for instance, fell to $540 million from $1.1 billion a year earlier, while manufacturing output contracted by 1.4 per cent for the first time in the country's fifty-year history.[29]

Summary

Summing up, the country's growth experience suggests some important macro-economic patterns and relationships that will be instrumental in affecting the country's future economic health:

- Highest growth (averaging 6.72 per cent per annum) occurred during the 1980s. This was also the period of highest annual savings and the smallest resource gap (difference between savings and investment).
- Also during this period, Net Factor Payments, consisting largely of remittances, were by far their highest. This influx of funds allowed the country to have the highest ratio of imports to production (Gross Domestic Product) in its history.
- The lowest growth (averaging 3.69 per cent per annum) occurred during the 1970s. During this period, investment's share of GDP reached a low of 16.4 per cent, with savings only slightly above the low period of the 1960s.
- In terms of trends, savings have gradually increased over time from a low of 12.69 per cent of GDP to 17.17 per cent in the 1980s, only to decline slightly to 17.18 per cent in the 1990s.
- Disregarding its decline in the 1970s, investment has also shown improvement over time, increasing from 16.83 per cent in the 1960s to 19.49 per cent in the 1990s. It should be noted however that both figures are very low by international standards, with the average saving and investment rates averaging in the mid-twenties for low-income countries and in the twenties for the South-East Asian Tigers.
- The country has gradually become integrated into the world economy as evidenced by exports nearly doubling their share of GDP (from 8.69 per cent in the 1960s to 16.31 per cent in the 1990s). Imports have shown a similar steady increase over time averaging 12.9 per cent in the 1960s and 19.98 per cent in the 1990s.

As noted above, the different economic priorities and policies of various administrations (Table 3) have no doubt modified this pattern of economic performance (Table 4):

- The Bhutto regime of the 1970s experienced the lowest savings and investment rates, with the average rate of growth of 4.3 per cent per annum only slightly above that of the 1960s.
- On the surface, economic performance was by far the best during the Zia regime, averaging over six and one-half per cent. However, a closer examination shows that this period was not characterized by a significant improvement in exports. Instead, the high level of imports was fueled largely by the fortuitous increase in remittances.
- The composition of consumption is consistent with this assessment. During the Zia administration, consumption was at an all time high, increasing to slightly over 90 per cent of GDP. Despite a period of relative peace with India, defence expenditures also reached a high of 6.75 per cent of GDP during the Zia years, with government expenditures increasing (19.54 per cent of GDP vs. 16.73 per cent) over that of the previous socialist regime.
- The figures on the composition of consumption also suggest that whatever gains the country had made in increasing savings had come about through the fall in private consumption. Public consumption actually increased over time (from 9.59 per cent of GDP during the Ayub years to nearly 14 per cent in the post-Zia period). Correspondingly, private consumption had fallen from slightly over 78 per cent during Ayub's regime to 71 per cent in the post-Zia era.
- A more ominous trend is the general tendency for increased government expenditures to outrun revenue collection. Expenditures increased from 15.56 per cent of GDP during the Ayub regime to 23.87 per cent in the post-Zia period. Correspondingly, revenues increased at a slower pace (from 12.69 per cent to 18.367 per cent), resulting in expanding the deficit from 2.87 per cent to 5.51 per cent.

Table 3
Economic Performance Since Independence: Summary

Government	Strength	Weakness	Distinguishing Aspects
Pre-Ayub (1947-57)	Rapid Expansion Large-Scale Manufacturing	Agricultural Stagnation	Neglect of Social Sectors
Ayub (1958-69)	Budgetary Stability	Limited Social Progress	Inward-Oriented High Growth
Z. Bhutto (1971-77)	Equity Concerns	Economic Decline Low Saving Rates	Nationalizations Private Sector Insecurity
Zia (1977-88)	High Growth	Limited Reforms Unsustainable Policies	High Remittances/ Foreign Assistance
B. Bhutto (1988-90)	Attempt at Stabilization	Sluggish Growth	Democratic Distribution
Sharif (1990-93)	Privatization	Budget Stabilization	Economic Liberalization
B. Bhutto (1993-97)	Continuation of Reforms	Budget Stabilization	Economic Mismanagement

- Unfortunately, constant data on the composition of savings was not developed until the early 1970s. Still, the observed patterns reinforce those noted earlier. In particular, whatever success the country has had in increasing savings must be attributed exclusively to the private sector. Savings from this source increased from 8.64 per cent during the Bhutto regime of the seventies to 12.79 per cent under Zia and up to 13.72 per cent in the post-Zia period. The corresponding figures for the public sector are 0.41, 1.80 and -0.25 per cent.
- It is interesting to note that public investment has not changed much over time, increasing from 9.05 per cent of GDP during Zulfikar Ali Bhutto's regime to 9.85 per cent

Table 4
Pakistan: Macro-economic Patterns by Administration, 1960–95

Year	GDP	Savings	Invest	Gap	Exports	Imports	NFP	CurrAcc	Defen	Fiscal Bal
1960		9.17	16.32	-7.15	8.74	13.11	0.13		4.36	-3.98
1961	0.00	12.22	16.18	-3.96	8.65	12.28	0.17		4.15	-4.26
1962	6.03	11.67	16.32	-4.65	9.91	13.85	0.32		3.73	-4.81
1963	7.68	12.09	19.12	-7.03	9.24	15.04	0.44		3.80	-2.69
1964	5.26	11.93	19.03	-7.10	9.05	17.04	0.40		3.99	-1.59
1965	3.66	14.75	16.98	-2.22	8.81	12.03	2.47		6.19	-1.86
1966	7.26	15.44	16.41	-0.97	8.26	13.14	2.95		6.84	-5.58
1967	-4.34	13.65	16.08	-2.44	8.75	11.17	0.25		5.58	-1.47
1968	5.07	13.06	16.11	-3.05	7.88	10.96	0.02		5.22	-1.80
1969	5.39	12.93	15.80	-2.87	7.62	10.35	0.13		5.42	-0.68
Ayub	4.00	12.69	16.83	-4.14	8.69	12.90	0.49		4.93	-2.87
1970	2.47	13.06	15.80	-2.74	7.62	10.35	0.00	-7.03	6.23	0.22
1971	0.76	13.02	15.64	-2.62	7.76	10.54	0.16	-5.63	6.86	-1.28
1972	0.56	12.88	14.17	-1.30	7.25	8.75	0.18	-3.06	7.55	-3.20
1973	6.61	14.16	12.93	1.23	14.89	14.36	0.69	-1.96	7.02	-4.29
1974	5.72	10.35	13.37	-3.02	13.77	17.50	0.71	-6.23	6.83	-3.14
1975	4.52	9.29	16.23	-6.93	11.57	20.50	1.02	-10.36	6.69	-4.69
1976	4.67	14.83	18.22	-3.39	10.51	18.06	2.26	-7.09	6.14	-3.52
1977	3.74	14.42	19.27	-4.85	9.34	17.86	3.66	-7.01	6.04	-2.75
Bhutto	4.30	12.65	15.70	-3.05	11.22	16.17	1.42	-5.95	6.71	-3.60
1978	7.85	15.74	17.86	-2.12	9.43	18.48	6.88	-3.37	5.82	-3.19
1979	4.91	14.71	17.88	-3.16	11.03	21.80	7.45	-5.65	6.20	-3.45
1980	8.58	15.80	18.48	-2.68	12.57	23.27	7.79	-4.80	6.22	-1.27
1981	7.00	17.43	18.76	-1.33	12.84	22.33	8.16	-3.65	6.37	-2.89
1982	6.52	15.36	19.45	-4.09	10.28	21.33	7.89	-5.00	7.05	-1.55
1983	6.77	19.28	18.79	0.49	12.18	22.51	10.81	-1.78	7.39	-3.52
1984	5.15	17.14	18.27	-1.13	11.40	21.97	9.43	-3.20	7.31	-2.76
1985	7.55	14.41	18.32	-3.91	10.57	22.60	8.11	-5.41	6.76	-3.66
1986	5.51	18.99	18.76	0.23	12.29	20.11	8.04	-3.92	6.92	-3.24
1987	6.47	20.21	19.13	1.08	13.81	19.09	6.35	-2.18	7.21	-3.04
1988	7.61	16.75	18.01	-1.26	13.86	19.43	4.31	-4.37	6.96	-5.67
Zia	6.72	16.89	18.52	-1.63	11.84	21.17	7.75	-3.94	6.75	-3.11
1989	4.99	16.28	18.93	-2.65	14.07	20.35	3.64	-4.18	6.64	-6.25
1990	4.41	17.79	18.93	-1.14	14.79	20.24	4.31	-4.73	6.86	-3.30
1991	5.46	19.73	18.96	0.78	16.93	18.49	2.34	-4.76	6.33	-6.54
1992	7.83	18.03	20.15	-2.12	17.27	20.42	1.04	-2.75	6.26	-6.42
1993	1.91	15.35	20.70	-5.35	16.20	22.30	0.74	-7.12	6.52	-6.54
1994	3.77	16.50	19.52	-3.02	16.25	19.00	0.26	-3.78	6.00	-5.72
1995	4.48	16.55	18.71	-2.15	16.41	19.40	0.81		5.46	-3.81
Post Zia	4.69	17.18	19.41	-2.24	15.99	20.03	1.88	-4.66	6.29	-5.51

Compiled from International Monetary Fund, International Financial Statistics. All non-GDP variables defined as shares of GDP.

under Zia, falling to 8.62 per cent in the post-Zia regimes. Contrary to popular opinion, private investment as a share of GDP was slightly higher under Bhutto (7.56 per cent) than under Zia (7.51 per cent). This index increased fairly dramatically to 9.26 per cent during the post-Zia years.

- As noted, aid and remittances have fallen off considerably in recent years. Remittances reached a high of 45 per cent of gross domestic investment under Zia. In the post-Zia years this figure has averaged only 21.44 per cent.
- Increased current account deficits in an environment of falling aid and remittances have resulted in a fairly dramatic expansion in the country's external debt. Already fairly high by low and middle income country standards, Pakistan's external debt servicing as a share of exports increased from 18.3 per cent in 1980 to 22.8 per cent in 1990 and 35.3 per cent by 1995. The corresponding figures for low income countries were 9.6, 20.1, and 15.4 per cent.

Empirical Relationships

Several studies have attempted to quantify these relationships and in particular those factors that have contributed to the country's pattern of expansion (Figure 5).

Source of Growth
With regards to the sources of growth:

1. Physical capital accumulation played a very important role in Pakistan's growth performance—overall and in the manufacturing sector. The fixed investment rate grew steadily during the 1970s and then stabilized at around 17 per cent of GDP in the mid-1980s. This allowed the capital stock, economy-wide and in the manufacturing sector, to expand fairly rapidly which in turn supported a substantial increase in the capital labour ratios and labour productivity.

2. Accumulation of labour also played a significant role in overall economic growth, although the statistical significance of labour in explaining growth in the manufacturing sector came out as rather low. The relatively weaker statistical significance of the labour coefficient, especially in the manufacturing growth equation, reflects the growing capital intensity of production. But it is also an indication that population growth may be too rapid, particularly with Pakistan's very low skills level. The increase in capital intensity could be the effect of two forces at work. First, Pakistan's macro-economic policies have generally favoured greater capital intensity of production, resulting from under-priced capital imports due to overvalued exchange rate (well into the mid-1980s), low interest rates and other incentives. Second, external migration of skilled and semi-skilled labour in the 1970s and early 1980s that tended to raise real wages.
3. Greater trade liberalization, as measured by the increase in the ratio of total value of exports and imports to GDP had a strong positive impact on Pakistan's growth performance. Again, however, that statistical significance of trade policy surprisingly was reduced in the case of the manufacturing sector. Nevertheless, the strong positive role of greater trade openness suggests that Pakistan needs to continue with further trade reforms to enhance competition and economic efficiency.
4. The structural change variable included capturing the impact of the change in the policy regime in Pakistan from the interventionist policy regime of the 1972-78 period to the market-oriented economy since 1978, camp up with a significant coefficient in the case of both aggregate and manufacturing sector growth equation. This result is explained by the major improvement in efficiency resulting from the reduction in controls and bureaucratic interventions. Estimates of total factor productivity (TFP) confirm this finding as well—TFP change was negative in first period as compared with the positive contribution of TFP change to

> growth in the later period. Once again, this reinforces the importance of further progress with economic liberalization.[30]

Unfortunately, as noted above, savings and investment rates in Pakistan are unusually low, averaging annually 14.8 per cent and 19.6 per cent of Gross National Product during the five years 1995-96.[31] At these low rates of savings and investment, it would not be possible to support future economic growth of 7 per cent a year. Seven per cent growth is socially necessary, in view of the country's neglected infrastructure system and low levels of investment in social sectors. Efforts to maintain a high rate of growth without mobilizing more national savings would result in a rapid accumulation of non-concessional external debt with serious consequences for the balance of payments position of the country in the not too distant future.

Various reasons have been put forward to explain Pakistan's poor savings performance. These include the existence of a large, unorganized underground or 'black' economy whose savings are not captured in official statistics; a feudal outlook characterized by wasteful expenditure; conspicuous consumption and ostentatious living; a development strategy which has emphasized the production of consumer goods; rates of inflation higher than the rate of return on savings; a high population growth rate with a resulting high dependency ratio; the low level of per capita income; and deficiencies in the methods used to prepare official statistics of savings.[32]

The most frequently cited reason, however, is culturally induced bias in favour of consumption.[33] But while such a bias would affect the propensity to save, it cannot by itself explain all aspects of Pakistan's savings performance and by constantly citing this factor, the importance of other determinants tends to be either disregarded or discouraged. Empirical evidence has shown that inadequate returns on financial savings and unequal and inefficient distribution of credit have exercised an inhibiting impact on the process of savings and investment. Admittedly the real rate of return is not the only determinant of savings, but

the evidence suggests that it is a far more important factor than often acknowledged by policy makers.[34]

The savings/investment relationships are clearly the crucial factors affecting the country's economic destiny at this point in time.

Macroeconomic Linkages

Because of the importance of defence expenditures in the government's budget, any discussion of macroeconomic patterns and linkages would be incomplete without the explicit introduction of this variable.[35] Here the main linkages between defence expenditures and economic activity are assumed to be both direct (as with Keynesian demand creation) and indirect (through possible deficit-induced crowding out of private activity and/or diversion of private savings to the public sector. Concerning the more important individual equations:[36]

- **Gross Domestic Product** is affected mainly by expansion in the private and public stocks of capital, employment and military expenditures. Here it should be noted that the links between GDP and non-defence expenditures were not statistically significant.
- **Employment** increases with an expanded population together with increments to the stock of public infrastructure.
- **Defence** expenditures expand in line with the general size of the economy. However, allocations to the military compete with infrastructure for funding. In addition, expanded levels of foreign borrowing in the previous year constrain allocations to the military. The same is also true for increased levels of indebtedness to the international institutions.
- **Non-defence public expenditures** also expanded in line with GDP. However, allocations to this category were reduced by short run increases in the defence budget.
- **Gross National Savings** expand with the general growth of the economy. However, these funds are pre-empted

(or crowded out) by the current fiscal deficit, as well as the deficit in the previous year.

- **Private investment in large-scale manufacturing** followed a lag adjustment pattern whereby investment in any one year was undertaken to bridge the gap between investor's optimal and actual capital stocks. The optimal level of private investment was in turn influenced by defence expenditures and ability to attract foreign funding. Again, however, this category of private investment was crowded out by the fiscal deficit.
- **Private investment in non-manufacturing activities** expanded with the total size of the economy and availability of savings. In contrast to investment in manufacturing however, this type of investment was discouraged by expanded defence expenditures.
- **Government credit** from the monetary system was also related to past deficits and short run movements in defence expenditures.
- **Inflation** is largely a function of expanded credit to the public sector, together with movements in the international price level.
- **Public borrowing in the domestic markets** was largely a function of the fiscal deficit. However, the authorities' ability to borrow internationally reduced some of the pressures on the domestic capital markets.
- **Public borrowing in the foreign capital markets** was also largely a function of the fiscal deficit. Again, however, increase in defence expenditures *ceteris paribus* reduced the amount of funding from this source.

In summary, the model captures the fundamental dilemma facing Pakistani policy-makers. Looked at in isolation, defence expenditures have tended to positively influence the economy. However, if these expenditures are funded with increased level of deficit financing, the subsequent crowding out of private investment may actually result not only in increased inflation, but, more importantly, in a net negative impact on the economy.

The inability of non-defence expenditures other than infrastructure to impact positively on the economy has only compounded this dilemma. In any case, the concern of external creditors over the country's high defence burden will in all likelihood increasingly constrain allocations to the military.

Prospects for the Future

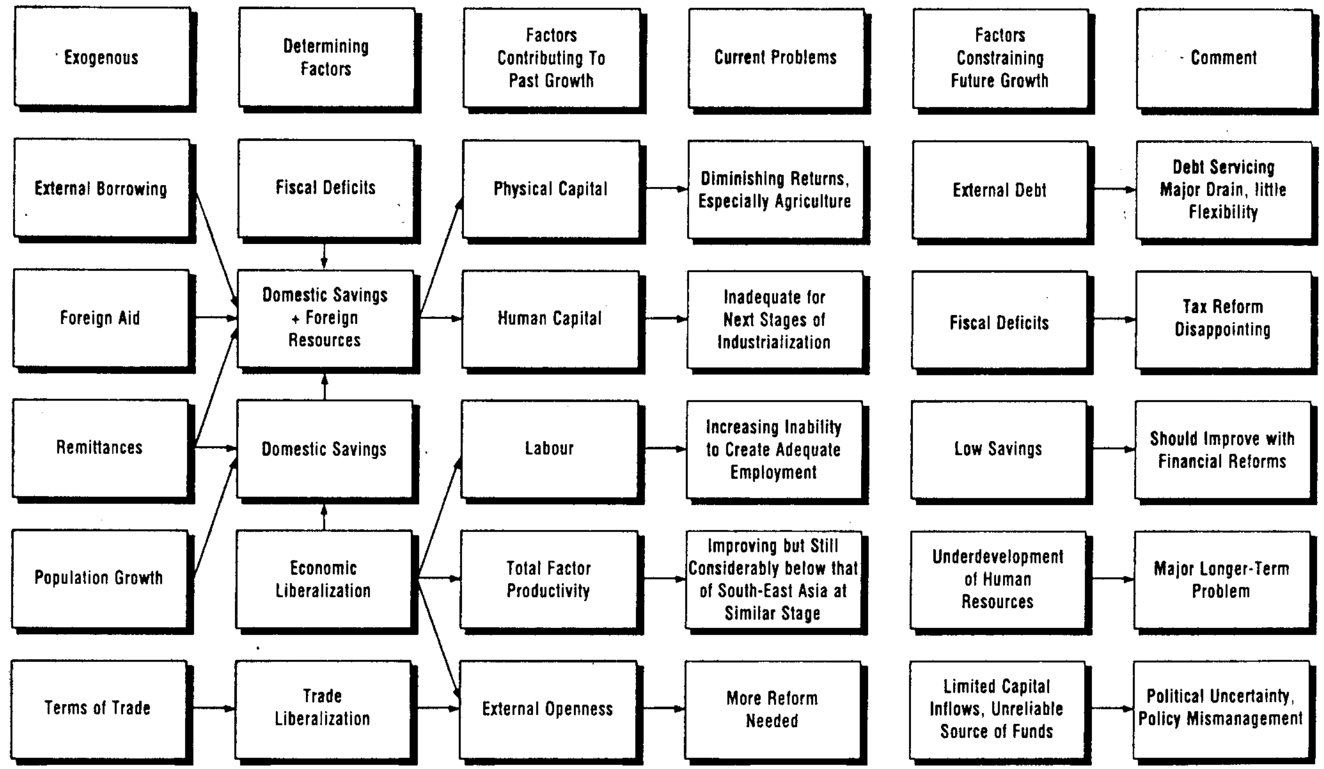
Realistically Pakistan's fiscal options for the foreseeable future are likely to be narrowly constrained by the International Monetary Fund (IMF), with the most recent package, anticipated at around $1.6 billion, to be approved before the end of October 1977.[37] It should, however, be noted that the past record of IMF programmes in the country has not been good, with bad feelings occurring on both sides.[38] During the past decade Pakistan has entered into six IMF programmes, but each was aborted mid-term when the country failed to meet its key conditions. Part of the problem has been widespread tax evasion which has led revenues to trail behind collection targets, with the budget deficit staying above estimates.[39] Clearly, to restore a stable growth path, the country will have to chart out medium-term objectives that are realistic and consistent.

Policy Constraints and Objectives

As a starting point, the macroeconomic relationships outlined above were used to assess the extent to which the following set of objectives are attainable over the period to the year 2000 and under what conditions. These include:

1. A stable rate of GDP growth of between 6.0 per cent and 7.0 per cent per annum—this is in line with the average rate of growth since 1976.
2. Employment growth of 2.8 per cent to 3.1 per cent—around the rate of growth of population and consistent with past rates of job creation.
3. Inflation, 5 per cent or lower—somewhat below the historical range of 7-8 per cent.

Figure 5
Pakistan: Source of Growth and Constraint



4. Foreign borrowing to expand at a rate slower than the general expansion in economic activity; this is, around 5 per cent or less.
5. Defence expenditure to decline to around 4-5 per cent of GDP—down from the 6-7 per cent range in the late 1980s and early 1990s.
6. Government deficits to fall to 3-4 per cent of GDP-down from the 6 per cent figure reached in the early 1990s.
7. A general expansion in the share of savings in GDP up toward the range of 18-20 per cent—typical values for countries at Pakistan's stage of development.
8. An expanded share of private investment in GDP.

Policy Simulations

Using a policy oriented macroeconomic model of the economy, several policy packages were examined in terms of their ability to improve the country's economic fortunes. The main findings of these simulations are summarized in Figure 6.

In summing up, the fiscal pattern that developed in Pakistan during the 1980s and extending into the 1990s is not sustainable. Over-expansion in expenditures, both for defence and non-defence purposes, together with sluggish revenues and excessive foreign borrowing have created a situation in which growth will be increasingly constrained by debt servicing, inflation, and shortages of domestic savings for private investors.

However, given the complex nature of defence expenditures in both stimulating and suppressing growth, budgetary reductions in this are by themselves unlikely to improve the country's economic performance. In fact, rapid reductions in defence are likely to impair the situation even further. On the other hand, modest efforts in tax reform are by far the most effective means for restoring fiscal stability.[40] The optimal policy mix is one of tax reform together with defence expenditures expansion that is constrained in the 2.5 per cent range. Unforeseen events aside, this package would enable the country to meet the goals established by itself and its major creditors in

restoring a rapid, self-sustaining growth in an environment characterized by a declining defence burden.

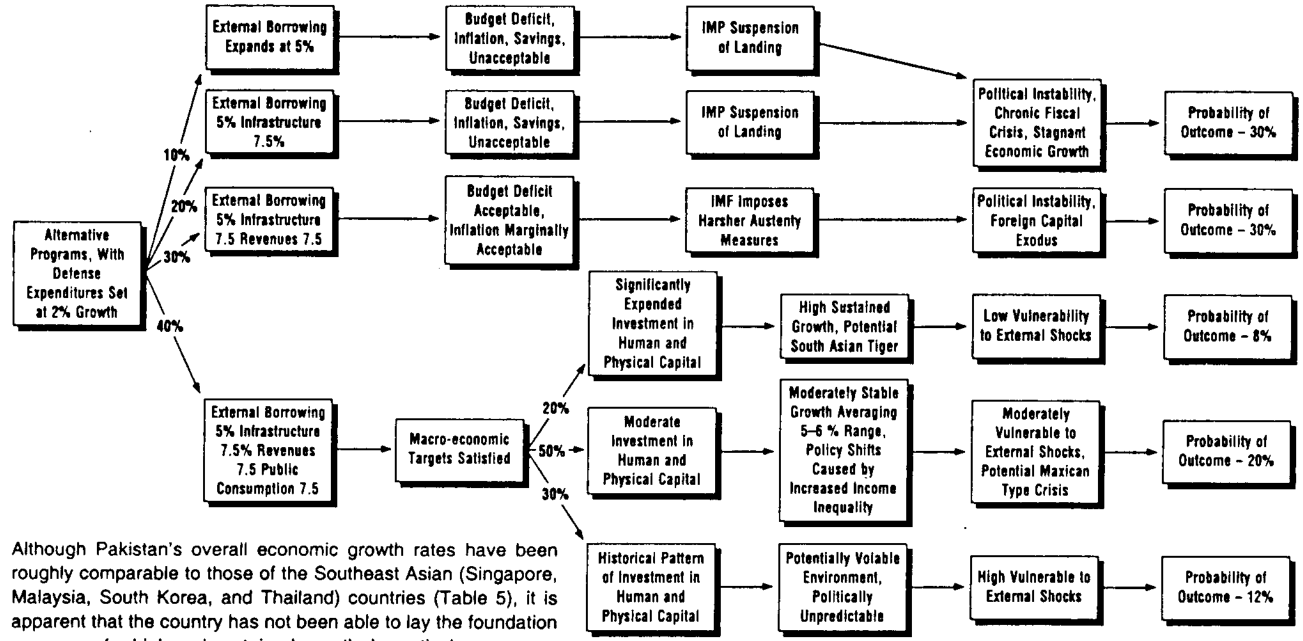
Implications

The results summarized above are suggestive of the country's future macroeconomic environment. They show that the country has, through fiscal reforms, the potential of sustaining a relatively high rate of economic expansion throughout the 1990s. Combining the fiscal simulations summarized above with an (admittedly subjective) estimate of their likely occurrence, the country has, in most likelihood, a probability of around 40 per cent of sustaining a strong economic expansion through the remainder of the 1990s (Figure 6).

A broader issue is whether this expansion is broad-based enough and sustainable to the point that the country might evolve into a dynamic South Asian Tiger. The Japanese like to compare Asia's economic development to a formation of flying geese with Japan, whose economic miracle started in the 1950s, at its head. Japan was followed by Hong Kong, South Korea, Singapore, and Taiwan. In the 1970s, Indonesia, Malaysia, and Thailand joined the flock. In the 1980s came China. An obvious question is whether the latter 1990s will see some of the countries of South Asia join the flock.[41]

In this regard, the present Southeast Asian Tigers have a number of characteristics that set them apart from Pakistan and most other developing countries. These include the following:

1. More rapid output and productivity growth in agriculture.
2. Higher rates of growth of manufactured exports.
3. Earlier and steeper declines in fertility.
4. Higher growth rates of physical capital supported by higher rates of domestic savings.
5. Higher initial levels of growth rates of human capital.
6. Generally higher rates of productivity growth.
7. Declining income inequality and reduced poverty.



Although Pakistan's overall economic growth rates have been roughly comparable to those of the Southeast Asian (Singapore, Malaysia, South Korea, and Thailand) countries (Table 5), it is apparent that the country has not been able to lay the foundation necessary for high and sustained growth. In particular:

1. The country's savings rate is one of the lowest in the world.
2. Export performance has been erratic.

Although Pakistan's overall economic growth rates have been roughly comparable to those of the Southeast Asian (Singapore, Malaysia, South Korea, and Thailand) countries (Table 5), it is apparent that the country has not been able to lay the foundation necessary for high and sustained growth. In particular:

1. The country's savings rate is one of the lowest in the world.
2. Export performance has been erratic.
3. Manufacturing has not shown an ability to grow at a faster rate than the overall economy.
4. Government consumption accounts for a relatively high share of the GDP.
5. The country's population growth rate remains relatively high.
6. As opposed to the Southeast Asian countries, Pakistan would be beginning its phase of high growth with an extremely high debt ratio.
7. By most measures, Pakistan's military expenditures are considerably above those in Southeast Asia.

Most important, the country has seriously neglected the development of human capital. The country's literacy rate of 38 per cent is one of the lowest in the world. Educational facilities are unevenly distributed and generally favour urban areas. Mortality and life expectancy indicators are similarly disappointing for a country of Pakistan's economic standing. Health coverage is limited, and heavily focused on urban areas and hospital-based curative care. The data paint a stark picture:[42]

- Two-thirds of Pakistan's adult population and over three-quarters of adult women are illiterate.
- Basic health facilities are not available to over half the population.
- Sixty-seven million people lack access to safe drinking water while eighty-nine million are without elementary sanitation facilities.
- A quarter of newborn babies are malnourished.

Table 5
International Comparison of Economic and Social Performance

Measure	Region			
	Total	SE. Asia	S. Asia	Pakistan
Economic Performance (% Growth)				
Gross Domestic Product, 1970-80	4.9	8.2	4.1	4.9
Gross Domestic Product, 1980-91	2.8	7.5	5.2	6.1
Investment, 1970-80	6.5	10.5	7.3	3.7
Investment, 1980-91	0.3	7.8	4.0	5.6
Exports, 1970-80	4.0	7.9	2.3	0.7
Exports, 1980-91	4.7	10.7	7.9	9.9
Government Expenditures, 1970-79	8.1	9.4	5.9	7.4
Government Expenditures, 1981-91	0.8	4.9	5.0	7.0
Population, 1970-80	2.6	2.	2.4	3.1
Population, 1980-91	2.5	1.8	2.2	3.1
Economic Structure (% GDP)				
Investment, 1970	21.7	28.0	17.3	16.0
Investment, 1991	20.5	37.8	20.7	19.0
Savings, 1970	18.6	20.3	13.7	9.0
Saving, 1991	14.0	36.3	14.7	12.0
Private Consumption, 1970	69.1	67.8	76.0	81.0
Private Consumption, 1991	72.2	52.5	73.7	75.0
Exports, 1970	22.7	43.3	12.3	8.0
Exports, 1991	28.5	83.3	17.7	16.0
Resource Balance, 1970	-2.7	-7.5	-3.7	-7.0
Resource Balance, 1991	-6.8	-1.5	-6.0	-7.0
Government Consumption, 1970	13.8	12.3	10.3	10.0
Government Consumption, 1991	13.9	11.5	11.7	13.0
Manufacturing, 1970	14.2	17.3	16.0	16.0
Manufacturing, 1991	15.2	28.0	16.3	17.0
Infrastructure Investment (% Growth)				
Paved Roads, 1970-80	8.6	8.5	5.6	4.4
Paved Roads, 1980-90	3.0	4.8	5.3	8.6
Irrigated Land, 1970-80	4.5	2.5	1.6	1.3
Irrigated Land, 1980-90	2.4	1.5	1.0	1.5
Electric Generating Capacity, 1970-80	8.9	11.8	6.6	8.3
Electric Generating Capacity, 1980-90	6.2	7.9	10.1	10.0

Table 5 (continued)
International Comparison of Economic and Social Performance

Measure	Region			
	Total	SE. Asia	S. Asia	Pakistan
Debt (%)				
External Debt/Exports 1980	152.4	90.7	156.1	208.8
External Debt/Exports 1991	392.3	65.4	250.4	244.9
External Debt/GDP 1980	40.9	34.2	33.5	42.4
External Debt/GDP 1991	82.5	33.7	50.7	50.1
Debt Service/Exports, 1980	17.3	15.0	13.1	17.9
Debt Service/Exports, 1991	21.0	9.5	21.9	21.1
Military (Average % Share)				
Defence Expend/Budget, 1970-80	15.2	22.0	17.7	29.5
Defence Expend/Budget, 1980-91	16.1	18.9	17.0	26.2
Arms Imports/Total Imp., 1970-80	8.5	2.4	5.3	8.5
Arms Imports/Total Imp., 1980-91	17.7	1.3	6.9	6.9
Defence Expend/GDP, 1970-80	5.6	9.1	7.0	6.1
Defence Expend/GDP, 1980-91	5.6	9.1	7.0	6.1
Armed Forces/1000 Pop., 1970-80	7.1	10.8	3.3	6.5
Armed Forces/1000 Pop., 1980-91	8.0	12.2	3.4	6.3
Social				
Population per Physician, 1970	15470.4	4047.5	5033.3	4310.0
Population per Physician, 1990	10570.2	2472.5	2700.0	2940.0
Life Expectancy (years) 1991	60.4	71.0	63.3	59.0
Illiteracy (%) 1991	37.4	11.0	43.0	65.0
Malnourishment (%), 1991	25.4	25.0	51.0	57.0
Education (% Relevant Age Group in School)				
Primary School, 1970	71.9	94.5	70.7	40.0
Primary School, 1990	87.5	99.0	80.3	37.0
Secondary School, 1970	20.8	34.8	28.7	13.0
Secondary School, 1990	39.8	61.0	46.7	22.0
Tertiary School, 1970	8.1	11.0	4.5	4.0
Tertiary School, 1970	10.8	17.5	3.5	3.0
Primary Pupil/Teacher Ratio, 1970	38.5	38.3	41.0	41.0
Primary Pupil/Teacher Ratio, 1990	35.4	25.0	51.0	41.0

Sources: Economic/Social, World Bank, Military, United States Arms Control and Disarmament Agency.

The unequal distribution of human capital in turn has created an income distribution much more unequal than found in Southeast Asia. Most analysts feel that the success of the Southeast Asian economies is linked to their initial, equitable distribution of income and assets.

Given the budgetary constraints that the government is likely to be faced with during the remainder of the decade, it is difficult to see how the country could significantly improve its social infrastructure. Without these human assets and capabilities, the country will be unable to achieve the productivity increases necessary to transform itself, certainly in the near future, along the lines of the Southeast Asian model.

Conclusions

It is remarkable that despite a troubled and crisis prone political history, Pakistan has managed to make significant strides in several spheres, including rapid economic growth, and industrial development. Much of this has occurred despite and not due to official policy or action, encouraging the belief among most Pakistanis that less government is the key to a better future.[43]

Returning to the questions posed at the start of this paper, while it is unlikely that the country will become a South Asia Tiger in the near future, one cannot rule this out in the longer term. Human capital deficiencies aside, in many respects Pakistan is better positioned now to move ahead with rapid economic development. If the Cold War's end forced difficult adjustments, it also opened new opportunities. Its situation next to the newly independent and resource-rich region of Central Asia means that Pakistan could become of central importance to this area.[44]

The majority of the country's population remains poor no doubt, largely because of limited economic freedom. Government controls restricting access to opportunity, together with a budgetary process dominated by the country's elite and biased against human capital development, have prevented the spread of economic prosperity to the mass of the population.

Less certain is the extent to which democracy can be sustained in light of the massive economic, and social difficulties the country currently faces. If the current government can press ahead with broad based reforms that provide more economic freedom in the longer run prospects for democracy may improve.[45] Robert Barro has examined the links between economic freedom, development and democracy.[46] His findings suggest that:

- The favourable elements for growth include small distortions of market prices, an inclination and ability of the government to maintain the rule of law, high levels of health and education, low government spending on consumption, and a low fertility rate. If these variables and the level of pre-capita income are held constant, the overall effect of more democracy on the growth rate is moderately negative.
- There is some indication that more democracy raises growth when political freedom is low, but depresses growth once a moderate amount of freedom has been attained.
- There is a stronger linkage between economic development and the propensity to experience democracy. Specifically non-democratic countries that have achieved high standards of living—measured by real per capital GDP, life expectancy and schooling—tend to become more democratic over time. Examples include, Chile, South Korea, and Taiwan.
- Conversely, democratic countries with low standards of living tend to lose political rights. Examples include the newly independent African states in the 1970s.

In Pakistan's case, high growth during the Zia years may have contributed to the desire for greater participation. In turn, no doubt this led to improved democracy under Benazir Bhutto and greater economic freedom under Nawaz Sharif. Improving the position and efficiency of the private sector offers a major opportunity to encourage that segment of the economy to expand its saving and investment. In addition, finding a greater role for the private sector in the politics of the country will broaden the state's legitimacy.

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